IT 99-5
Tax Type: Income Tax
Issue: Apportionment: One Factor/Three Factor Application Issues
Foreign Source Dividends In The Sales Factor

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
v.	)	No. 94-IT-0000
	)	FEIN: 36-0000000
"KARLOFF LABORATORIES, INC.",	)	Tax Yrs. 12/90-12/91
Taxpayer.	)	

ORDER AND MEMORANDUM DECISION ON TAXPAYER'S MOTION FOR PARTIAL SUMMARY JUDGMENT AND ON THE DEPARTMENT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

This matter arose after "Karloff Laboratories, Inc." ("Karloff" or "taxpayer") protested a Notice of Deficiency ("NOD") the Illinois Department of Revenue ("Department") issued to "Karloff) regarding tax years ending 12/31/90 and 12/31/91. The NOD proposed to increase "Karloff's" Illinois income tax liability for those years because the Department determined that "Karloff" should have included certain gross receipts in the sales factor of its apportionment formula.

Following a period of discovery, each party filed a motion for partial summary judgment.[1] The parties' cross-motions take contrary positions regarding the Department's

[1]. The parties' motions do not indicate whether "Karloff" has waived the second issued presented in its protest, or whether there has been some agreement resolving

authority to include in the sales factor of "Karloff's" apportionment formula the gross amount of dividends "Karloff" received from its foreign and "Virgin Island" subsidiaries, the gross amount of dividends "Karloff" received from its foreign sales corporation, the gross amount of dividends "Karloff" received from domestic companies owed less than 50% by "Karloff", and the full amounts reported by "Karloff" on its federal consolidated corporate income tax returns pursuant to section 78 of the Internal Revenue Code ("the

See

modifications, those amounts were not included as part of "

subject to apportionment under the provisions of the Illinois Income Tax Act ("IITA").

e parties' motions, the exhibits and affidavits attached thereto,

recommendation a summary of the material facts not in dispute. I recommend partial

Karloff", and partial summary judgment be denied for

Facts Not In Dispute

Together with its foreign and domestic subsidiaries, "

business of producing and selling health care products, including pharmaceuticals,

chemical and agricultural products. Memorandum in Support of "

Motion for Summary Judgment ("

Memorandum of Law in Support of Its Cross-Motion for Summary Judgment and

("Department's Memo"), pp. 4-5.

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that issue. *See* Department's Memo, Exhibit I, p. 3. Therefore, I am considering the parties' motions to be cross-motions for partial summary judgment.

2. "Karloff" has wholly-owned and partially owed subsidiaries which are organized and operating in the United States and in foreign countries. "Karloff's" Memo, p. 2; Department's Memo, p. 6.

3. "Karloff" has wholly-owned subsidiaries incorporated in "California" and conducting business in the "Virgin Islands" ("Virgin Island subsidiaries"). "Karloff's" Memo, p. 2; Department's Memo, p. 6.

4. During tax years 1990 and 1991, "Karloff" received dividends from different payors, including the following companies:

   * Certain "Foreign Subsidiaries" of "Karloff", to wit: "Lugosi Laboratories"; "Roundabout Co., Ltd."; "Karloff Laboratories, S.A."; "Deutschemacher Karloff"; "Karloff Laboratories de Mexico S.A. de C.V."; "Karloff B.V."; "Arozco B.V."; "Karloff France S.A."; "Karloff Laboratories"; and "Howard Hughes Realty, Inc". ("Karloff's" Memo, p. 1 & n.1, and Exhibits A, D thereto); (Department's Memo, Exhibits M, N and Q). "Karloff" owned at least 80% of the stock of all the foreign subsidiaries identified here except, "Roundabout" and "Howard Hughes Realty, Inc". ("Karloff's" Memo, Exhibit A; Department's Memo, p. 9 & n.5, and Exhibit Q thereto).

   * "Karloff Chemicals Inc.", "Karloff Health Products, Inc.", "Karloff's" "Virgin Island" subsidiaries. ("Karloff's Memo, p. 1 & n.2; Department's Memo, Exhibit Q).

   * "Karloff Trading Co., Inc"., "Karloff's" foreign sales corporation ("FSC"). ("Karloff's" Memo, p. 1 & n.3; Department's Memo, Exhibit Q).

   * "FALZ Pharmaceuticals Inc". and "NBC Uniforms", unaffiliated domestic companies in which "Karloff" owned less than 50% of the voting stock. ("Karloff's" Memo, p. 1 & n.4; Department's Memo, Exhibit Q).

5. None of the companies identified immediately above was a member of "Karloff's" unitary business group, as that term is defined in the IITA. "Karloff's" Memo, pp. 3-4; 35 **ILCS** 5/1501(a)(28).

6. For tax years 1990 and 1991, and pursuant to Section 78 of the Code, "Karloff" reported foreign dividend gross-up amounts of $71,047,420 and $73,950,227, respectively. "Karloff's" Memo, p. 4; Department's Memo, p. 9.

7. During the Department's audit of "Karloff's" returns, the Department included in the numerator and denominator of "Karlof""s sales factor the full amount of the dividends "Karloff" received from its foreign and "Virgin Island" subsidiaries, from its FSC and unaffiliated domestic companies, and the full amounts reported pursuant to section 78 of the Code. Department Memo, p. 11; "Karloff's" Memo, pp. 6-7.

8. "Karloff" contends that dividends it received from non-unitary domestic companies would be includable in its sales factor to the same extent as such dividends would be included in its base income. "Karloff's" Opposition to the Department's Cross Motion for Summary Judgment and "Karloff's" Reply Brief in Support of its Motion for Summary Judgment (""Karloff's" Reply"), pp. 11-12. "Karloff" also contends that dividends it received from foreign subsidiaries in which it held less than 80% ownership would be includable in its sales factor to the same extent as such dividends would be included in its base income. *Id.*

9. The NOD proposed to assess Illinois income tax in the amount of $5,816,359, plus interest. Department's Memo, Exhibit G; "Karloff's" Memo, pp. 7-8.

10. "Karloff" did not include 15% of the dividends it received from "Roundabout" and "Howard Hughes Realty, Inc.", the foreign subsidiaries it owed less than 80%, in its Illinois sales factor. *See* "Karloff's" Memo, Exhibit A (dividends received from "Roundabout" and "Howard Hughes"), Exhibit D, pp. 28 (of the section re: "Karloff's" 1990 Illinois returns) 25 (of the section re: "Karloff's" 1991 Illinois returns); Department's Memo, pp. 9-10 (the $30,700 and $1,656 the Department identified under the heading "<u>≤80%</u>" as being the amounts it included in "Karloff's" base income for years 1990 and 1991, respectively, equal 15% of the dividends "Karloff" received from "Roundabout" and "Howard Hughes" for those respective years).

Conclusions of Law:

A motion for summary judgment is appropriate where the pleadings, affidavits, and other documents on file show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. 735 **ILCS** 5/2-1005; People *ex rel.* Department of Revenue v. National Liquors Empire, Inc., 157 Ill. App. 3d 434 (4th Dist. 1987). In this case, the parties agree that there is no dispute regarding the facts material to the issue presented.

The issue is whether, as a matter of law, dividends and Section 78 Gross-up amounts which are excluded from base income may be included in the apportionment factor to calculate "Karloff's" Illinois income tax liability. "Karloff" argues that the amounts excluded from its base income must also be excluded, to the same extent, from its Illinois apportionment formula. The Department contends that the dividends and Section 78 Gross-up are includable in the sales factor of the apportionment formula if "Karloff's" cost of performance regarding such receipts is in Illinois. *See, e.g.*, Department Memo, pp. 15-18; Transcript Of Oral Argument Re: Cross-motions For Summary Judgment ("Tr."). pp. 53-54.

The issue involves two different sections of the IITA which, together, provide the framework for measuring the portion of business income, earned within the water's edge by a corporation engaged in a unitary business within and outside Illinois, that is subject to Illinois income tax. The provisions of Article 2 of the IITA identify, *inter alia*, the Illinois income tax rates and those items of income that make up a taxpayer's base income. The provisions of Article 3 identify the various means by which a taxpayer's base income is to be allocated or apportioned.

Specifically, section 201(a) of the IITA imposes a tax on the "net income" of every corporation that earns income within the state. 35 **ILCS** 5/201(a). Section 202 defines "net income" as "that portion of . . . base income for such year . . . which is allocable to this State under the provisions of Article 3 . . . ." 35 **ILCS** 5/202. For

corporations, "base income" is defined as the corporation's "taxable income" as modified by Section 203(b)(2). **ILCS** 5/203(b)(1). Section 203(e)(1) provides that "taxable

tax purposes for the taxable year under the provisions of the Internal Revenue Code." 35 **ILCS**

items specified in subparagraphs (A) through (E) and by subtracting certain items specified in subparagraphs (F) through (Q). **ILCS** 5/203(b)(2).

ed in a unitary business operating in more than one state, section 304 prescribes an apportionment formula designed to

income tax. 35 5/304(e). Illinois has adopted the "combined water's edge method" to determine the portion of unitary business income to attribute to income earned within

Caterpillar Financial Services v. Whitley, 288 Ill. App. 3d 389, 392 (1st Dist.

In Caterpillar Financial Services

determined using Illinois' combined water's edge method of reporting and apportionment:

> In general terms, the Illinois combined water's edge
>
> unitary corporations by an apportionment percentage calculated using a three-factor formula. The factors include
> The total for each factor for the corporation subject to Illinois tax is compared to the total
>
> group and is expressed as a fraction, *i.e.*
> each factor is the amount of Illinois property, payroll or sales and the denominator of each factor is the amount of
>
> The sales factor is then double-weighted. The percentages determined by dividing each numerator by each
>
> the domestic unitary group is multiplied by the average percentage figure to determine the amount of income
>
> Under the Illinois method of calculating "water's

> edge" income, corporations that have 80% or more of their property and payroll in foreign countries are not included in the unitary business group. [citation omitted] As a result, neither the income nor the factors (property, payroll, sales) of the foreign businesses are included in the combined apportionment calculation.

Caterpillar Financial Services v. Whitley, 288 Ill. App. 3d at 393.

The apportionment factor at issue here is the sales factor. At the heart of the Department's motion is its argument that the calculation of the apportionment formula is an operation that is separate and distinct from the calculation of base income. The Department contends that since the calculations are distinct, amounts excluded from base income may still be considered when calculating the formula designed to apportion the taxable business income of a person subject to Illinois income tax. As evidence that the two processes are distinct, the Department stresses that section 1501(a)(21) of the IITA defines "sales" as "all gross receipts of the taxpayer not allocated under Sections 301, 302 and 303." The Department argues that the statutory definition of sales includes more than just business income, and that, in any event, "Karloff" has conceded that the dividends were apportionable business income because it did not include such amounts on its schedule of non-business income. Finally, the Department argues that during the tax years at issue, there was no provision prohibiting it from including in the apportionment fraction the gross receipts at issue here.

"Karloff" argues that the Department's interpretation of the term "sales" to include the full amounts of dividends received from its FSC, from its foreign, "Virgin Island", and unaffiliated domestic companies, and the full amounts reported as section 78 gross-up -- even though such amounts are wholly or largely excluded from its base income subject to Illinois apportionment -- is inconsistent with any fair understanding of the provisions of the IITA, or with legislative intent underlying Illinois' adoption of water's edge combined apportionment. "Karloff" argues that the term "sales" must be read in context with the other parts of the IITA, and points out that section 3 of the IITA is

expressly designed to allocate or apportion items of a taxpayer's base income. "Karloff" contends that, in context, the only dividends which may be included within its apportionment factor are those amounts of dividends included in its base income. Finally, and central to its claim for refund, "Karloff" argues that if the Department seeks to include foreign source dividends in "Karloff"'s sales factor, the Department is obliged to include in "Karloff"'s apportionment fraction the factors of the foreign subsidiaries from whom such dividend payments were made to "Karloff".

"Karloff" contends that the issue in this case has already been decided by the Illinois Supreme Court in Continental Illinois National Bank v. Lenckos, 102 Ill. 2d 210, 224 (1984). In Continental, the taxpayer deducted from base income interest it received on obligations of the U.S. Government. *Id.* at 221. The Department included this interest in the sales factor even though it was not included in base income. *Id.* In its briefs and during oral argument, "Karloff" pointed out the similarity between the Department's argument here and the same argument it made before the Illinois Supreme Court in Continental. "Karloff's" Reply, Exhibit C, p. 4 (the calculation of the sales factor is an operation that is separate and distinct from the calculation of base income); Tr. pp. 32-36. The Continental court held that if it allowed the Department to include the interest received on U.S. obligations in the apportionment formula, the Department would be doing indirectly what it could not do directly, i.e., it would be taxing income that was clearly tax exempt. Continental, 102 Ill. 2d at 224. "Karloff" argues the holding in Continental that is critical to this dispute was made regarding the state's argument that the IITA required it to consider gross receipts from both taxable and tax-exempt interest within the Illinois apportionment formula. "Karloff's" Memo, pp. 18-19 (*citing* Continental, 102 Ill. 2d at 22). In response, the court held:

> We do not agree. "The purpose of the apportionment formula is to confine the taxation of business income to that portion which is attributable to activities in Illinois." [citation omitted] It is illogical to assume that the General

> Assembly would devise a formula which includes income that is clearly tax exempt.

Continental, 102 Ill. 2d at 224.

The Department argues that the rule in Continental does not apply to this case because that case involved the Supreme Court's interpretation of a federal statute which prohibited any taxation of income from certain federal instruments. While I agree that the premise for the ruling in Continental was federal preemption (*see id.* at 225, "We conclude, therefore, on the basis of the relevant Federal statute and the recent decision of the Supreme Court in *American Bank & Trust Co. v. Dallas County*, ... that tax-exempt interest may not be taken into consideration in apportioning taxable income."), I cannot agree that the decision has no application here. Most significantly, the Continental court recognized that including gross receipts in the apportionment fraction where such amounts are excluded from base income amounts to the indirect taxation of such income. *Id.* at 224. In Continental, the locus of the intent to exempt the income at issue from any state taxation was Congress. The federal government, however, is not the only source of jurisdictional power affecting the Department's authority to tax the income of those doing business within its borders.

Of all the various items of gross receipts the Department contends should be included in "Karloff"'s apportionment fraction, the Illinois General Assembly itself has decided that most of some of the receipts,[2] and all of the other gross receipts, constitute income that was never intended to be part of a corporation's base income subject to Illinois apportionment. Thus, the rule in Continental can be reconciled with the facts of

[2]. Only 20% of the dividends "Karloff" received from unaffiliated domestic companies owned less than 50% by "Karloff", and 15% of the dividends "Karloff" received from foreign companies owned less than 80% by "Karloff", are included in "Karloff's" base income. *See* Department's Memo, pp. 9-10; "Karloff's" Memo, pp. 5-6.

General Assembly would devise a[n apportionment] formula which includes income that

understanding of the rule in Continental

audit practice regarding the gross receipts at issue here. It is also consistent with other Illinois court rulings interpreting the General Assembly's adoption of water's edge

"Karloff" contends that the Department's longstanding audit policy had been to include gross receipts from dividends in the apportionment fraction, but only if those

See "Karloff's" Memo, pp. 11-

To support its contention, "Karloff" appends to its motion copies of the deposition testimonies of Department auditors involved with the audit of "Karloff's" returns during

see also "Karloff's" Motion to

Compel"), Exhibit A (1/16/97 deposition, pp. 13-17)) and a copy of a report completed during the course of informal review conducted in this matter.

G. "Karloff" also cites a private letter ruling issued by the Department in 1991 in which the Department informed a taxpayer that it would include in the sales factor only those

"Karloff's" Memo, pp. 11-12

(Private Letter Ruling ("PLR") IT-91-76). "Karloff" contends that the Department's prior audit policy was consistent with legislative intent, as reflected by

which he proposed a system of water's edge combined apportionment. "Karloff's" Memo,

In its reply, the Department suggests that any policy it may have had regarding apportioning only those receipts included in base income was not longstanding.

had is irrelevant if the audit procedure used here is consistent with law. *See* Department's Memo, pp. 20-21.

In the deposition transcript which is part of the record in this matter, Department audit supervisor Thomas Donnelly testified that the Department began including the dividends at issue in the sales factor in 1991. "Karloff's" Motion to Compel, Exhibit A (1/16/97 deposition, pp. 13-17). The change was made following a non-domiciliary corporate taxpayer's request to include the gross amounts of dividends received within the denominator of its Illinois sales factor. *Id.* pp. 13-14.[3] Prior to that time, the Department had not included the dividends in the sales factor unless, in Donnelly's words, "the dividends were [an] includable type of business income . . . ." *Id.*, p. 17. A deposition may be used in lieu of an affidavit to articulate facts supporting entry of summary judgment. Certified Mechanics Construction Co. v. Wight & Co., 162 Ill. App. 3d 391, 402-03 (2d Dist. 1987). Statements in an affidavit are taken as true unless the nonmoving party presents counter-affidavits to contradict them. Fooden v. Board of

[3]. The auditor's deposition testimony reflects that some corporations headquartered outside Illinois might encourage Department auditors to include the gross amount of dividends in the denominator of Illinois' sales factor, and thereby reduce Illinois' apportionable share of the corporation's income earned within the water's edge. *See* "Karloff's" Reply, p. 17. And even if they did not actively encourage the Department to do so, corporations headquartered outside Illinois ordinarily would not object to the Department's consideration of the gross amount of dividends they received within the denominator of their Illinois sales factor. *See* Ball v. Village of Streamwood, 281 Ill. App. 3d 679, 688 (1st Dist. 1996) ("Can any rational person expect the beneficiaries of the exemption to seek a declaration of its invalidity?").

Governors, 48 Ill. 2d 580, 587 (1971).

Here, "Karloff" established that, prior to 1991, the Department generally considered within the sales factor only those amounts of dividends that had not been eliminated from base income. There is no triable issue of material fact regarding whether the Department's past audit policy, in fact, existed. It did. The Department's suggestion that its past policy was erroneous, by citing to a 1996 private letter ruling revoking the 1991 letter ruling, merely crystallizes the issue presented by the parties' motions. Which "policy" comports with the provisions of the IITA? I conclude the audit position defended by the Department in this matter is inconsistent with Illinois law.

In General Telephone Co. v. Johnson, 103 Ill. 2d 363 (1984), the Illinois supreme court was called upon to review the legislature's adoption of waters' edge combined apportionment after it had previously allowed world-wide combination by its ruling in Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102 (1981). The supreme court conducted that review when addressing the first issue in General Telephone, which the court articulated as, "whether Public Act 82-1024, by prohibiting the use of combined apportionment, altered the law regarding invested capital taxes in such a way that its retroactive effect interferes with the taxpayer's right to due process." 103 Ill. 2d at 368. Immediately after identifying the first issue in General Telephone, the court wrote:

> To resolve this issue, we must examine the details of this taxpayer's protest suit, as well as the Messages Tax Act language imposing the invested-capital tax, in light of some related developments concerning the Illinois Income Tax Act [citations omitted].
>
> Before considering the relevant provisions of our revenue laws, however, it is helpful to recognize several accounting principles that operate in the State income tax context. . . .
>
> * * *
>
> The Illinois Income Tax Act, which imposes a tax on net income, reflects these accounting principles. . . .
>
> * * *
>
> The language itself of section 304(a) does not

> authorize combined apportionment. However, corporations that were plaintiffs in *Caterpillar Tractor Co. v. Lenkos* argued that, as members of a unitary business group, they should be allowed under section 304(a) to apply combined apportionment in the following manner: . . .
>
> In *Caterpillar*, this court approved the use of combined apportionment under section 304(a) of the Income Tax Act. . . .
>
> In February 1981, then, we approved combined apportionment for application to the combined worldwide income of Caterpillar Tractor Company and its 25 subsidiaries. The next year, our General Assembly addressed combined apportionment in an amendment to the Income Tax Act. The amendment added a provision that expressly requires combined apportionment for taxpayers who, by statutory definition, are unitary business group members. The legislature rejected worldwide combined apportionment, however, and instead adopted a domestic version which excludes from the unitary business group any member whose activities are carried on primarily outside the United States. *This domestic combined apportionment also strictly limits formulary consideration of foreign dividend income as well as sales between United States and foreign members of the same unitary group.* . . .

General Telephone Co. v. Johnson, 103 Ill. 2d at 368-73 (emphasis added).

When asked to comment regarding the italicized portion of the Illinois Supreme Court's opinion in General Telephone at oral argument, counsel for the Department argued that the quote was *dicta*. Tr. pp. 58-61. However, even if it were *dicta*, I would still consider highly persuasive the Illinois supreme court's recognition that, by adopting water's edge apportionment, the legislature intended to strictly limit formulary consideration of foreign dividend income. Department of Public Works & Buildings v. Butler Co., 13 Ill. 2d 537, 545 (1958) (*dicta* is "entitled to consideration as being persuasive, but, as a general rule, is not binding as authority or precedent within the rule of *stare decisis*.").

Giving no recognition to the Illinois supreme court's analysis in the General Telephone opinion, the Department argues that when the legislature adopted water's edge combined apportionment, it intended only to prohibit the combination of corporations if

more than 80% of one of the corporation's business activities were conducted overseas. Department's Memo, pp. 23-24. Curiously,[4] the Department argues that the legislature's adoption of water's edge apportionment "did not affect indirect taxation of income generated by foreign members." *Id.* p. 25. The Department asks why, if the legislature intended to "close the door to indirect taxation of foreign dividends", it created subtraction modifications which have restrictions depending on the percentage of ownership. *Id.* n.19 (quoting "Karloff's" argument).

Both parties cite the Governor's amendatory veto message to support their respective arguments. *See* Department's Memo, pp. 23-26 & Exhibit R; "Karloff's" Memo, pp. 12-17 & Exhibit H. As part of his amendatory veto, Governor Thompson

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[4]. The Department's argument regarding legislative intent and the "indirect taxation of income generated by foreign members" (*see* Department's Memo, pp. 23-25 & n.19) is curious because it alludes to a second purpose for § 304. The purpose traditionally identified with the apportionment formula is "to confine the taxation of business income to *that portion [of business income] which is attributable to* activities in Illinois." Continental Illinois National Bank v. Lencks, 102 Ill. 2d at 224 (emphasis added). But the Department's argument suggests that it is appropriate to consider the gross receipts at issue within the apportionment formula because the legislature intended section 304 to impose an indirect income tax on items of income that are not included in a taxpayer's base income. That allusion, of course, must be rejected. The Illinois income tax is a direct tax imposed on the privilege of earning or receiving income within or as a resident of Illinois. 35 **ILCS** 5/201(a). There is no indirect tax imposed on those privileges, and the tax that *is* imposed is measured by net, and not gross, income. 35 **ILCS** 5/202.

declared:

> Pursuant to Article IV, Section 9(e) of the Illinois Constitution of 1970, I hereby return HOUSE BILL 2588 entitled "AN ACT relating to taxation and amending an Act herein named" with my specific recommendations for change.
>
> HOUSE BILL 2588 prohibits combined reporting by corporations. . . .
>
> Because of both the complexity and importance of this issue, an extensive amount of analysis and consultation has been undertaken during my review. After a careful deliberation, I am convinced that with my recommendations for change Illinois can serve as a model for the rest of the states in its tax treatment of multinational and multistate corporations.
>
> * * *
>
> First, I am recommending that Illinois statutes clearly define a unitary group as one in which the members are in the same line of business, are on the same apportionment formula, and are functionally integrated. . . .
>
> Second, with my changes, I am rejecting world-wide unitary reporting. . . .
>
> World-wide unitary is clearly an undesirable form of state taxation, yet domestic combination with clearly defined provisions can prove to be a benefit to many businesses. . . . Domestic combined reporting allows firms to more clearly reflect the income attributable to Illinois. For these reasons, I am recommending combined reporting for domestic members of a unitary group.
>
> Third, in order to treat multinational businesses fairly in relation to domestic businesses, two further changes are recommended. Dividends from foreign subsidiaries should be treated in the same manner as dividends from domestic subsidiaries. Also, sales between domestic and foreign members of a unitary group should be treated the same way we treat intercompany sales between members who are totally domestic. These changes are an important economic development incentive.
>
> By eliminating the differential treatment of foreign and domestic dividends a thorn in the side of Illinois multinational businesses can be removed. This differential is particularly costly to businesses headquartered in Illinois. Treating foreign dividends fairly will make Illinois very attractive to multinational businesses and serves as a clear

incentive to locate corporate headquarters here in Illinois.

See Department's Memo, Exhibit R; "Karloff's" Memo, Exhibit H.

I agree with the Department that multinational companies headquartered in Illinois might, to use the Department's words, do "something" within Illinois that helps their foreign subsidiaries earn sufficient profit outside the water's edge for the subsidiary to return a portion of that profit to the Illinois parent in the form of a dividend. *See* Department's Memo, pp. 28-29. The legislature clearly wanted businesses to come and do "something" in Illinois; it was one of the reasons the Governor expressed when he vetoed and proposed his amendment to H.B. 2588. By adopting water's edge combined apportionment, the legislature, *inter alia*, intended to provide an economic incentive for companies to locate corporate headquarters within Illinois. The incentive would be accomplished, the legislature agreed, by treating domestic and multinational businesses fairly vis-a-vis their receipt of foreign dividends. As part of its adoption of water's edge combination, and to insure that such businesses would be treated similarly in this regard, the legislature created a subtraction modification which excluded some of the dividends at issue in this case from a corporation's base income. Ill. Rev. Stat. ch. 120, ¶ 2-203(b)(2)(J) (1982) (*now* 35 **ILCS** 5/203(b)(2)(*O*)).

For almost a decade after the General Assembly adopted water's edge apportionment, the Department acted as though it agreed with the Supreme Court's description of Illinois' system of water's edge combination and apportionment, as articulated in General Telephone. Specifically, the Department treated foreign and domestic dividends similarly by including them in the sales factor only to the extent such dividends were also included in the corporation's base income. *See* "Karloff's" Motion to Compel, Exhibit A (1/16/97 deposition, pp. 13-17); PLR IT-91-76. But sometime after 1991, the Department apparently determined that the Illinois General Assembly really intended the Department to treat foreign and domestic dividends similarly by considering both types of dividends (as well as any amounts reported pursuant to § 78 of the Code) to

be items of business income subject to allocation or apportionment, even though such amounts were largely excluded from the taxpayer's base income. The Department's revised interpretation of the governor's veto message simply turns the legislature's expressed intent on its head.

Statutes are meant to be read as a whole, taking into consideration each part or section in connection with every other part. Antunes v. Sookhakitch, 146 Ill. 2d 477, 484 (1992). By reading the definition of the term "sales," as that term is used in Article 3, out of context with Article 2, the Department has unreasonably interpreted the provisions of the IITA. The Department's unreasonable interpretation is reflected by its arguments that: "The sales factor measures Taxpayer's business activities related to sales (including intangibles such as dividends) and is determined separately from taxable base income or 'income net of expenses.'"; and "Without fair apportionment of the income-producing activity conducted in ["Karloff's"] Illinois offices the State would suffer a loss of substantial revenue related to this activity." Department's Memo, pp. 3, 45 (respectively).

The IITA does not impose a tax measured by *activities conducted within Illinois*; it imposes a tax measured by net income. 35 **ILCS** 5/201(a), 5/202, 5/301(c). During the years at issue, the tax measured by "Karloff's" net income was 4.8 % of *that portion of its base income* allocable [or apportionable] to Illinois. 35 **ILCS** 5/201(b)(7), 5/202 (net income defined); *see also* 86 Ill. Admin. Code § 100.3320(a) ("... the [taxable] portion of the net income ... shall be determined by apportionment ....") (1984).

Since the Illinois income tax is not a tax measured by activity, section 304 cannot have been designed to apportion *income-producing activity conducted in Illinois*. Nor is section 304(a)(3) designed to determine whether gross receipts related to nontaxable sales income belong in the numerator or denominator of the sales factor, based on the situs of activities related to the production of such income. First and foremost, section 304 is designed to measure the percentage of apportionable business income that is subject to Illinois income tax. Continental Illinois National Bank v. Lenckos, 102 Ill. 2d at 224.

The only items of business income that are apportionable to Illinois are those items of business income included within base income. 35 **ILCS** 5/301(c); 86 Ill. Admin. Code §§ 100.3300, 3320(a). Section 304(a)(3) is designed to measure the percentage of a corporation's apportionable business income related to sales, by dividing the amount of gross receipts from apportionable sales in Illinois by the amount of gross receipts from apportionable sales everywhere. 35 **ILCS** 5/304(a)(3)(A); Continental Illinois National Bank v. Lenckos, 102 Ill. 2d at 224; Caterpillar Financial Services v. Whitley, 288 Ill. App. 3d at 393.

Within the context of section 304(a)(3), the process of investigating whether income-producing activity related to sales occurred inside or outside Illinois is relevant when determining whether gross receipts related to apportionable sales income belong in the numerator or denominator of the sales fraction. 35 **ILCS** 5/202; 86 Ill. Admin. Code § 100.3320(a). To the extent dividends are included within the recipient corporation's base income, then an investigation regarding the income-producing activities related to such sales would be relevant and appropriate. But section 304(a)(3) does not require an investigation to determine the situs of income-producing activities related to items of income *that were never intended to be subjected to Illinois income tax*. Such an investigation has no relevance to whether particular gross receipts related to apportionable sales income belong in the numerator or denominator of the sales fraction. 86 Ill. Admin. Code § 100.3320(a).

The legislature clearly classified the lion's share of the dividends and other gross receipts the Department seeks to indirectly tax here as items of income which were never intended to be subject to Illinois income tax. That is why Illinois suffers no loss by excluding such amounts, to the same extent, from "Karloff's" sales factor. When measuring Illinois' apportionable share of "Karloff'" combined unitary business income from sales in this case, the Department should not have counted or considered how many gross receipts were attributable to sales income that was not apportionable. By including

the gross amounts of dividends and section 78 amounts within "Karloff's" sales factor, the Department proposes to assess, indirectly, Illinois income tax on income the legislature classified as not being subject to tax.

The text and context of the IITA, as well as the legislature history behind P.A. 82-1029, support "Karloff's" contention that the IITA's definition of "sales" should be understood to mean "all gross receipts [included within base income and] not allocated under 301, 302, and 303." I cannot conclude that the legislature intended to indirectly tax all foreign dividends received or reported by multinational businesses headquartered in Illinois, while simultaneously reducing, to the same extent, Illinois' apportionable share of the combined domestic base income of a unitary business group whose parent is headquartered within the United States, but outside Illinois.

"Karloff" has conceded that where the Illinois General Assembly has deemed it appropriate to include certain types and amounts of dividends within the combined base income of a unitary business group, the same amounts of gross receipts may be included in the apportionment formula. That concession is consistent with the Department's past audit practice, and with the system the Illinois supreme court recognized was designed to strictly limit formulary consideration of foreign dividend income. That is the system which existed before the legislature amended section 304 to prohibit the consideration of any amounts of dividends, section 78 amounts, etc., within the sales factor on returns filed regarding subsequent tax years. 35 **ILCS** 5/304(a)(3)(D).[5] I recommend the

[5]. Public Act 87-389 added subparagraph (D) to § 304(a)(3) effective January 1, 1996. That provision prohibited the inclusion of dividends, section 78 amounts and Subpart F income in the numerator or denominator of the sales factor for tax years ending after 12/31/95 to 12/31/97. There is a patent difference between behavior that is "strictly limited" and behavior that is "prohibited." Prior to the amendment to § 304(a)(3), the

Director conclude that, for the years at issue, the Department was limited to considering within "Karloff's" sales fraction only those amounts of dividends that were also included within its combined unitary base income.

As a final note, "Karloff" made certain constitutional arguments related to the Department's denial of an amended return and claim for refund "Karloff" filed regarding the tax years at issue. *See* Tr. pp. 37-45. Specifically, "Karloff" argued that if the Department were allowed to indirectly tax the foreign dividends by including them in its Illinois apportionment formula, it was obliged to also include in "Karloff's" apportionment formula the property and payroll factors of the dividend payors. "Karloff's" Memo, pp. 20-21; Tr. pp. 38-39. Since I am recommending that the Director order the Department to revise the NOD so as to exclude from "Karloff's" sales factor all gross receipts from dividends but for those amounts that are also included within "Karloff's" base income, I make no recommendation regarding "Karloff's" constitutional arguments. *But see* Caterpillar Financial Services v. Whitley, 288 Ill. App. 3d 389 (3rd Dist. 1997).

WHEREFORE, UPON ACCEPTANCE OF THE DIRECTOR, IT IS ORDERED THAT:

1. "Karloff's" motion shall be and the same is hereby granted, and partial summary judgment is entered for "Karloff". The Department's motion is denied.

2. The NOD shall be revised to exclude the following items from "Karloff's" sales factor:

Department was not *prohibited* from considering gross receipts related to dividends and other sales income within the sales factor, it was just *strictly limited* to considering therein only those gross receipts related to income the legislature intended to be apportionable in the first place.

a) the full amount of dividends "Karloff" received from its foreign and "Virgin Island" subsidiaries;
b) the full amount of dividends "Karloff" received from its FSC;
c) the full amount of dividends "Karloff" received from unaffiliated domestic companies;
d) the full amounts reported pursuant to section 78 of the Code.

3. When revising the NOD, the Department shall include in "Karloff's" sales factor gross receipts from dividends paid to "Karloff" to the same extent such dividend income is included in "Karloff's" combined unitary base income.

Date 6/22/99

John E. White
Administrative Law Judge